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The Reduced Impact of §367(d) After the TCJA

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Following the Tax Cuts and Jobs Act ("TCJA"),[1] the U.S. tax consequences of a domestic corporation transferring intangible property to a controlled foreign corporation ("CFC") have dramatically changed. Both the costs and the benefits of such transfers have been significantly reduced, correspondingly reducing the stakes in a transfer pricing dispute.

To illustrate an application of the post-TCJA rules, assume a domestic corporation licenses intangible property to its wholly owned CFC and derives an annual royalty of $1,000. The CFC uses the intangible property in its business of manufacturing and selling products outside the United States to unrelated foreign customers, and earns $1,500 of sales income before the royalty expense. The CFC pays a 10% foreign income tax on its $500 of taxable income (i.e., $50).

The post-TCJA U.S. corporate income tax rate is 21% (vs. the pre-TCJA 35% rate). Royalty income derived by a domestic corporation from the license of intangible property for use outside the United States, however, generally qualifies for a lower tax rate that applies to foreign-derived intangible income ("FDII").[2] A deduction generally is provided for 37.5% of a domestic corporation's FDII with the result that the income is subject to an effective tax rate of 13.125%.[3]

In the above example, the domestic corporation would include in taxable income the $1,000 royalty, which would generally be subject to the 21% tax rate. Because the CFC uses the licensed intangible property to manufacture and sell property to unrelated foreign customers, the royalty should be eligible for the 13.125% tax rate (i.e., U.S. tax of $131.25).[4]

Prior to the TCJA, income earned by the CFC from exploiting the licensed intangible property generally would not have been subject to U.S. tax. Post-TCJA, income derived by a CFC from its business operations (reduced by a routine return on tangible assets) generally is included in the gross income of the CFC's U.S. shareholders under the global intangible low-taxed income ("GILTI") regime.[5] A deduction generally is permitted to domestic corporations for 50% of the GILTI inclusion, and thus such income generally is subject to a 10.5% U.S. effective tax rate.[6]

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[1] Pub. L. No. 115-97 (Dec. 22, 2017).

[2] §250(b)(3), §250(b)(5). *See* Yoder, *The Proposed FDII Regulations: Foreign Use of IP* 48 Tax Mgmt. Int'l J. 227 (May 10, 2019).

[3] The amount of a domestic corporation's intangible income is reduced by 10% of the average of the corporation's aggregate adjusted bases in depreciable tangible property giving rise to the intangible income. §250(b)(2) (cross-referencing §951A(d)). The gross amount of FDII is reduced by expenses properly allocable to the income. §250(b)(3)(A)(ii). Proposed regulations provide detailed rules for documenting that income is foreign derived. Prop. Reg. §1.250(b)-4, §1.250(b)-5, §1.250(b)-6.

[4] As mentioned above, the amount eligible for the lower tax rate would be reduced by a routine return on tangible property giving rise to the income and allocable expenses. U.S. tax on the FDII may be reduced by credits for foreign income taxes. §901(a).

[5] §951A(a). The income derived by the CFC is reduced by 10% of the average of the corporation's aggregate adjusted bases in depreciable tangible property giving rise to the intangible income, which would not be subject to U.S. tax. §951A(d)

[6] §250(a)(1). The deduction for FDII and GILTI is limited by the taxable income of the domestic corporation. For example, if the domestic corporation has a loss for the year after taking into account FDII and GILTI, such income would not benefit from the lower tax rates. §250(a)(2).

In the above example, the CFC's income from exploiting the licensed intangible property in foreign markets would not be subject to direct U.S. taxation. Under the GILTI regime, such income is included in the gross income of the corporate U.S. shareholder. A foreign tax credit may be claimed for 80% of the foreign income taxes paid on the GILTI (i.e., $40), subject to limitation.[7] The amount of the GILTI inclusion would be grossed up for 100% of the foreign income taxes deemed paid by the corporate U.S. shareholder (i.e., to $500),[8] and subject to a U.S. effective tax rate of 10.5% (i.e., $52.50).[9] The U.S. tax would be reduced by the $40 of deemed paid tax credits to $12.50.[10]

Now assume that the domestic corporation transfers the intangible property to the CFC in a tax-free §351 exchange. Section 367(d) provides that the transfer is treated as if the domestic corporation sold the intangible property to the CFC in exchange for annual royalty payments over the life of the intangible property. The amount of the royalty is commensurate with the income generated by the intangible property.[11]

Immediately after the transfer, the domestic corporation generally would include in income an annual deemed payment of $1,000 under §367(d).[12] The deemed royalty under §367(d) for intangible property used outside the United States should be eligible for the lower FDII effective tax rate of 13.125%.[13]

The CFC would earn $1,500 of income from manufacturing and selling products exploiting the intangible property that it now owns. While it would no longer have a royalty expense of $1,000 under the prior license agreement, it would deduct the annual §367(d) deemed royalty of $1,000 as an expense reducing the CFC's gross income for purposes of calculating its GILTI tested income.[14]

Thus, the U.S. tax consequences with respect to income earned from exploiting the intangible property may be similar immediately before and after the transfer of intangible property to the CFC. The domestic corporation would continue to pay 13.125% on its $1,000 of income, and the CFC would continue to derive $500 of GILTI included in the income of the domestic corporation and subject to a 10.5% tax rate, with the U.S. taxes reduced by deemed paid foreign tax credits.[15]

Under prior law, an IRS adjustment increasing the amount of the §367(d) deemed royalty would generally result in additional tax of 35% times the amount of the adjustment. For post-TCJA tax years, an adjustment to the transfer price generally would result in significantly less incremental U.S. tax.

For example, assume the IRS asserted that the amount of the §367(d) deemed royalty in the above example should be increased by $100. This would increase the amount of the domestic corporation's income subject to FDII by $100, but decrease the amount of the GILTI inclusion by $100. Considering the difference in the tax rates, this would result in a 2.625% additional tax cost (vs. 35% under prior law).

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[7] §960(d), §904(d)(1)(A).

[8] §78.

[9] The amount included in the U.S. shareholder's income would be reduced by a routine return which is determined by reference to the adjusted basis in tangible property used to produce the income. The sales income earned by the CFC should not be Subpart F income because the CFC manufactures the property it sells; however, if such sales income were Subpart F income, it would have been fully included in the U.S. shareholder's income and subject to a 21% U.S. tax rate. *See* §954(d) and Reg. §1.954-3(a)(4).

[10] A taxpayer may have other GILTI that is subject to a higher foreign income tax rate, in which case the U.S. tax on the $500 of GILTI may be reduced to zero by virtue of the excess foreign tax credits. On the other hand, expenses of the domestic corporation allocated to the foreign tax credit separate limitation category for GILTI may limit the ability to claim the full amount of the $40 as a credit.

[11] *See* Reg. §1.367(d)-1T(c)(1). The TCJA expanded the definition of "intangible property" and broadened the transfer pricing rules for determining the amount of the deemed royalty. Section 367(d)(2)(D), §367(d) (4)(F), §367(d)(4)(G). *See* Yoder, *U.S. Taxation of 'Intangible Income'*, 46 Int'l Tax J. 3 (Jan.-Feb. 2020); Yoder, *Code Sec. 367(a) & (d) After the TCJA*, 45 Int'l Tax J. 3 (Nov.—Dec. 2019).

[12] This amount of the annual deemed payment can vary depending on the transfer pricing methodology.

[13] Prop. Reg. §1.250(b)-3(b)(7), §1.250(b)-4(e)(4)(ii)(F) *Ex.* 6.

[14] Reg. §1.951A-2(c)(2)(ii). *See also* Reg. §1.367(d)-1T(c)(2)(ii) (deduction reduces Subpart F income to the extent properly allocated to such income).

[15] A foreign country may permit stepping up the basis in the transferred intangible property to fair market value and provide an amortization deduction, such that there may not be a material difference in the foreign tax costs after the transfer of the intangible property to the CFC. This would generally not be the case if the transfer resulted from converting a foreign disregarded entity into a regarded entity, because the foreign country would not recognize a transfer of intangible property and would not provide a deduction for the deemed §367(d) royalty. A branch conversion illustrates the inappropriate cost of subjecting a transfer of foreign goodwill and going concern value to §367(d) under the TCJA, which had not previously been subject to taxation. *See Amazon.com, Inc. v. Commissioner*, 148 T.C. 108 (2017), *aff'd*, 934 F.3d 976 (9th Cir. 2019). *See* Joint Committee on Taxation, *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Dec. 31, 1984), at 428 ("Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax" because goodwill and going concern value "are generated by earning income, not by incurring deductions," and therefore "the transfer of these (or similar) intangibles does not result in the avoidance of Federal income taxes.").

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Thus, the stakes with a transfer pricing adjustment are much less than they were under the pre-TCJA rules.[16]

Going forward, the CFC may be responsible for creating future value with respect to the transferred intangible property through its own activities and responsibilities for risk as well as developing value pursuant to a cost sharing agreement or research and development agreement. This can result in earning income from subsequent value creation under the GILTI regime rather than under the FDII regime. The immediate tax benefits, however, may not be materially increased, due to the small rate differential between taxes imposed on GILTI and FDII, and also the CFC would bear expenses for future development of the intangible property.

Thus, following the TCJA the costs of transferring intangible property to a CFC are reduced; albeit, the tax benefits are also reduced. Correspondingly, there generally should be significantly less at stake in the event the IRS asserted a transfer pricing adjustment. Indeed, reducing the role of tax in intangible property location decisions was one of the policy goals of the TCJA.

The above example is simplistic, as there are many variables that can materially change the illustrated results. These include transfer pricing methodologies, the value provided by the CFC and risks assumed, the expense allocation rules and foreign tax credit rules, as well as state and foreign income tax considerations. A decision to move intangible property offshore also would need to take into account where products are manufactured or services are performed, where customers are located, the current and future projected profit and loss profile of the company within the United States and globally, financing arrangements, and projections concerning changes in the U.S. and foreign tax laws.

[16] If the U.S. tax on the $100 of GILTI had been offset by excess foreign tax credits in the GILTI category, the stakes would be higher, but still materially less than incremental tax of 35%.

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